
INTRODUCTORY SECTION

for Fiscal Year ending June 30, 2006

Chairperson's Letter

Teachers' Retirement System of the State of Kentucky

GARY L. HARBIN, CPA
Executive Secretary



December 5, 2006

Dear Members:

On behalf of the Board of Trustees and staff, I am pleased to present this Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky for the year ending June 30, 2006, the 66th year of operation of the System. The accompanying reports from the independent auditor and the consulting actuary substantiate the financial integrity and the actuarial soundness of the system.

KTRS closed the 2005-2006 fiscal year with \$13.9 billion net assets. The active membership totaled 73,740 and the retired membership was 38,497 with an annual payroll of \$1.035 billion.

The Board of Trustees is totally committed to managing the retirement system funds in a prudent, professional manner. The retirement system is justly proud of the funding level that the system has achieved. Every effort will be made to insure that the system continues to operate in a fiscally sound manner. Present and future members of the system deserve to be able to avail themselves of the best possible retirement as authorized by statute.

We appreciate the support and cooperation extended by the Governor and the Legislature. This cooperation allows the system to not only meet current challenges but to also make timely provisions for the future.

The Board of Trustees pledges to continue to administer the affairs of the Kentucky Teachers' Retirement System in the most competent and efficient manner possible.

Sincerely,

Zella F. Wells
Chairperson
Board of Trustees

BOARD OF TRUSTEES

ZELLA F. WELLS
CHAIRPERSON
PAINTSVILLE

BARBARA G. STERRETT
VICE CHAIRPERSON
LEXINGTON

ROBERT M. CONLEY
PAINTSVILLE

JAY MORGAN
MURRAY

RONALD L. SANDERS
HODGENVILLE

RUTH ANN SWEAZY
TAYLORSVILLE

LAURA ZIMMERMAN
LEXINGTON

EX OFFICIO
GENE WILHOIT
COMMISSIONER
DEPARTMENT
OF EDUCATION

EX OFFICIO
JONATHAN MILLER
STATETREASURER

Letter of Transmittal



Teachers' Retirement System of the State of Kentucky

December 5, 2006

Honorable Ernie Fletcher, Governor
Commonwealth of Kentucky
Capitol Building
Frankfort, Kentucky 40601-3800

Dear Governor Fletcher:

It is my pleasure to submit the 66th Comprehensive Annual Financial Report of the Teachers' Retirement System of the State of Kentucky, a Component Unit of the Commonwealth of Kentucky, for the fiscal year ended June 30, 2006.

State law provides the legal requirement for the publication of this report; in addition, an annual audit and an annual actuarial valuation of the retirement system are also required.

Kentucky Teachers' Retirement System (KTRS) has produced an annual report that will provide you, the General Assembly, and the general public, with information necessary to gain a better understanding of the Teachers' Retirement System.

This Report Consists of Five Sections:

- ❖ The Introductory Section contains the Board Chairperson's letter, this letter of transmittal, Board of Trustees information, a list of consultants used by the System, and the organizational chart.
- ❖ The Financial Section contains the report of the independent auditors, management's discussion and analysis (MD&A), financial statements and required supplementary schedules. Charles T. Mitchell, LLP conducted the 2006 independent audit.

- ❖ The Investment Section presents investment and portfolio performance. This includes the policies, summary, and profile of the System's holdings.

- ❖ The Actuarial Section contains the certification from Cavanaugh MacDonald Consulting, LLC (the consulting actuary service) as well as the results of the System's actuarial valuation.

- ❖ The Statistical Section contains various information on the System's membership, both active and retired. A listing of all participating KTRS employers is also presented in this section.

This report has been prepared in conformity with the principles of governmental accounting and generally accepted accounting principles. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with KTRS management. To the best of our knowledge and belief, the enclosed data is accurate in all material aspects and reported in a manner designed to present fairly the financial position and results of operations of the System for the year ended June 30, 2006. Discussion and analysis of net assets and related additions and deductions is presented in the MD&A beginning on page 15.

Management is responsible for maintaining a system of internal controls to establish reasonable assurance that assets are safeguarded, transactions are accurately executed and financial statements are fairly presented. The system of internal controls includes policies and procedures and an internal audit department that reports to the Executive Secretary.

Profile of KTRS

Kentucky Teachers' Retirement System was established on July 1, 1940 as a cost-sharing multiple-employer defined benefit plan. The primary purpose of the plan is to provide retirement benefits to the educators and some public employees of the state. KTRS is a blended component unit of the Commonwealth of Kentucky. The plan is described in the notes to the basic financial statements on page 21. Also, the summary of the plan provisions starting on page 76 is useful in understanding benefit and

contribution provisions. The population of our membership is stated in the preceding chairperson's letter.

Each year an operating budget is prepared for the administration of the pension fund. The budget is approved by the Board of Trustees and then submitted to the Kentucky General Assembly for legal adoption. The KTRS investment earnings fund the budget appropriations.

Economic Condition

The economic condition of the System is based primarily on investment earnings. The Investment Section of this report starting on page 46 contains detailed analysis of investments. This section includes asset allocations, rates of return, discussion of the current year market environment and 10 year historical trend schedules.

The investment portfolio experienced significant growth during the 2005-2006 fiscal year. The portfolio's par value increased from \$12,899,431,557 to \$13,161,470,370. The growth of the portfolio was due to investment income that included realized capital gains. Employer and employee contributions also provided significant income to the portfolio.

Investment earnings, including appreciation of asset values, net of investment expenses for the 2005-2006 fiscal year were \$724,133,742. The majority of earnings from the System's investment portfolio were the result of net appreciation in fair value of investments in the amount of \$282,572,648. The second largest earnings component, \$262,392,472 was the result of interest income. Other income of \$179,168,622 was generated from dividends, rent and securities lending.

According to KRS 161.430 the KTRS Board of Trustees has the authority to invest the assets of the System. The Board of Trustees, generally, delegates investment authority to an Investment Committee that is comprised of two Trustees and the System's Executive Secretary. The Investment Committee works closely with experienced investment counselors, who are contracted by the Board of Trustees, and the System's professional staff in evaluating and selecting investments.

The investment objectives of the Board of Trustees are to ensure that funds shall be invested solely in the interest of its members and their beneficiaries and that investment income shall be used for the exclusive purpose of providing benefits to the members and their beneficiaries while making payment of reasonable expenses in administering the Plan and its Trust Funds. Also, the investment program shall provide a reasonable rate of total return with major emphasis being placed upon the protection of the invested assets. The entire portfolio earned a total return of 5.4% in 2005-06 and the portfolio's ten year annualized rate of return was 7.5%. During 2005-06, more than 72% of the fixed income investments were rated at least "AAA" in terms of credit quality.

On the state level, KTRS annuities have a bolstering impact on the state's economy, since around 93% of retired teachers reside in Kentucky. Total benefits (retirement, medical...etc.) paid last year were over \$1.195 billion.

Funding

Based on recommendations of the Board of Trustees, the General Assembly establishes the levels of contribution by statute that are to be made by members and employers to fund the liabilities of the system. Each year, an independent actuary performs a valuation to determine whether the current levels of contribution will be sufficient to cover the cost of benefits earned by members.

The latest actuarial valuation was for the period ending June 30, 2006. This report reflects the System's assets, based on modified market value; totaled \$14.5 billion and the liabilities totaled \$19.1 billion. The actuary determined that the existing levels of contribution by members and employers would be sufficient to fund all of the System's liabilities within a reasonable period of time. The report concludes that the System is operating on an actuarially sound basis. Assuming that employer contributions continue in the future at rates recommended on the basis of the successive actuarial valuations, the actuary states that the continued sufficiency of the retirement fund to provide the benefits called for under the System may be safely anticipated.

KTRS Medical Insurance Plan

KTRS health care costs keep escalating at a much faster clip than revenue growth in the Medical Insurance Plan. Last year, basic doctor/hospital costs and the cost of medications (prescription drugs) rose about 6.4%. An actuarial valuation of the Medical Insurance Plan for the fiscal year ended June 30, 2006 indicated that the fund has an unfunded liability of \$4.2 billion for 2006. The KTRS 2004-2006 biennial budget requested additional funding from the Commonwealth, but due to difficult economic times, these funds were not available.

Effective January 1, 1999 KTRS retirees and dependents under the age of 65 have their health insurance provided by plans managed by the Kentucky Department for Employee Insurance. Under this arrangement, KTRS provides a monthly supplement to assist the retiree and their dependents in purchasing their health insurance. Retirees 65 and over remain in the plan administered by KTRS. These retirees also receive a supplement for the cost of their coverage.

The System realizes that these means alone will not solve the medical insurance funding crisis. Additional steps must be taken through legislation on both the state and national levels in order for true cost control to result. Meanwhile, KTRS will address the problem by taking measures to contain costs and by increasing revenues to the insurance fund, adjusting coverage to meet existing revenues, or a combination of the two.

Professional Services

Professional consultants are appointed by the Board of Trustees to perform professional services that are essential to the effective and efficient operation of the KTRS. A certification from the certified public accountant and actuary are enclosed in this report. The system's consultants who are appointed by the Board are listed on pages 8 and 47 of this report.

Our Gratitude

Arthur W. Green, of Elkton, resigned from the Board of Trustees effective June 30, 2006. Mr. Green was elected to the Board in October 1997. Along with his service on various Board

committees, he also served as Chairman of the Investment Committee, Board Vice-Chairman and finally, Board Chairman from July 1, 2005 until June 30, 2006.

During Mr. Green's tenure on the Board, policies were adopted that have greatly improved benefits for Kentucky's retired educators, including the calculation of the retirement benefit on the three highest salary years of employment upon reaching age 55, the addition of the 3.0 percent multiplier for educators retiring with more than 30 years of service, and the addition of part-time teachers and substitute teachers to the field of membership.

On behalf of Kentucky's educators, KTRS staff extends thanks to Mr. Green for his dedicated service to the Kentucky Teachers' Retirement System and wishes him many happy and productive years.

National Recognition

The System was honored by two National professional organizations in regard to the administration of the retirement program.

GFOA Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2005. The Certificate of Achievement is a prestigious national award-recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The KTRS has received the Certificate of Achievement for the last

eighteen consecutive years (fiscal years ended 1988-2005). We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

PPCC Achievement Award

The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2006 for implementing and maintaining high professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure and are widely acknowledged to be marks of excellence for retirement systems. It represents the highest standards of excellence in the public pension industry.

The PPCC is a coalition of the four major public pension organizations in the nation. These include the National Association of State Retirement Administrators, The National Council on Teacher Retirement, the National Conference on Public Employees Retirement Systems, and the Government Finance Officers Association.

NCTR Executive Committee

Gary L. Harbin continues to serve on the Executive Committee of the National Council on Teacher Retirement (NCTR). NCTR is a national, nonprofit organization whose mission is to promote effective governance and benefits administration in state and local public pension systems in order that adequate and secure retirement benefits are provided to educators and other plan participants. NCTR membership includes 77 state, territorial, local and university pension systems with combined assets in excess of 1.4 trillion, serving more than 16 million active and retired teachers, non-teaching personnel and other public employees.

Public Sector HealthCare Roundtable

Mr. Harbin also serves on the Board of Directors and as Vice President of the Public Sector HealthCare Roundtable. The Roundtable is a national coalition of public sector health care purchasers that was formed to ensure that the

interests of the public sector are properly represented during the formulation and debate of federal health care reform initiatives.

Membership in the Roundtable is open to any statewide, regional or local governmental unit that provides health care coverage for public employees and retirees.

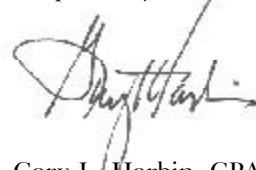
Acknowledgments

The preparation of this report reflects the combined efforts of the KTRS staff, under the leadership of the Board of Trustees. The report is intended to provide complete and reliable information that serves as a basis for making management decisions and for determining compliance with legal provisions. It is also used to determine responsible stewardship of the assets contributed by KTRS members and their employers.

This report is located at the KTRS web address www.ktrs.ky.gov, and is being mailed to all employer members of the System whose cooperation continues to contribute significantly to our success, and who form the vital link between KTRS and its active members.

KTRS management and staff are committed to the continued operation of an actuarially sound retirement system. The support that you have demonstrated in the past is an essential part of this commitment, and we look forward to continuing this positive relationship.

Respectfully submitted,



Gary L. Harbin, CPA
Executive Secretary

BOARD OF TRUSTEES



Dr. Zella F. Wells
Chairperson
Teacher Trustee
Paintsville



Barbara G. Sterrett
Vice Chairperson
Retired Teacher Trustee
Lexington



Robert M. Conley
Lay Trustee
Paintsville



Dr. Jay Morgan
Teacher Trustee
Murray



Ronald L. Sanders
Lay Trustee
Hodgenville



Ruth Ann Sweazy
Teacher Trustee
Taylorsville



Laura Zimmerman
Teacher Trustee
Lexington



Gene Wilhoit
Ex Officio Trustee
Commissioner,
Dept. of Education



Jonathan Miller
Ex Officio Trustee
State Treasurer

Kentucky Teachers' Retirement System

479 Versailles Road
Frankfort, Kentucky 40601-3800

ADMINISTRATIVE STAFF

GARY L. HARBIN, CPA

Executive Secretary

C. JOE HUTCHISON, MBA, CPA

Deputy Executive Secretary

PAUL L. YANCEY, CFA

Chief Investment Officer

PROFESSIONAL CONSULTANTS

ACTUARY

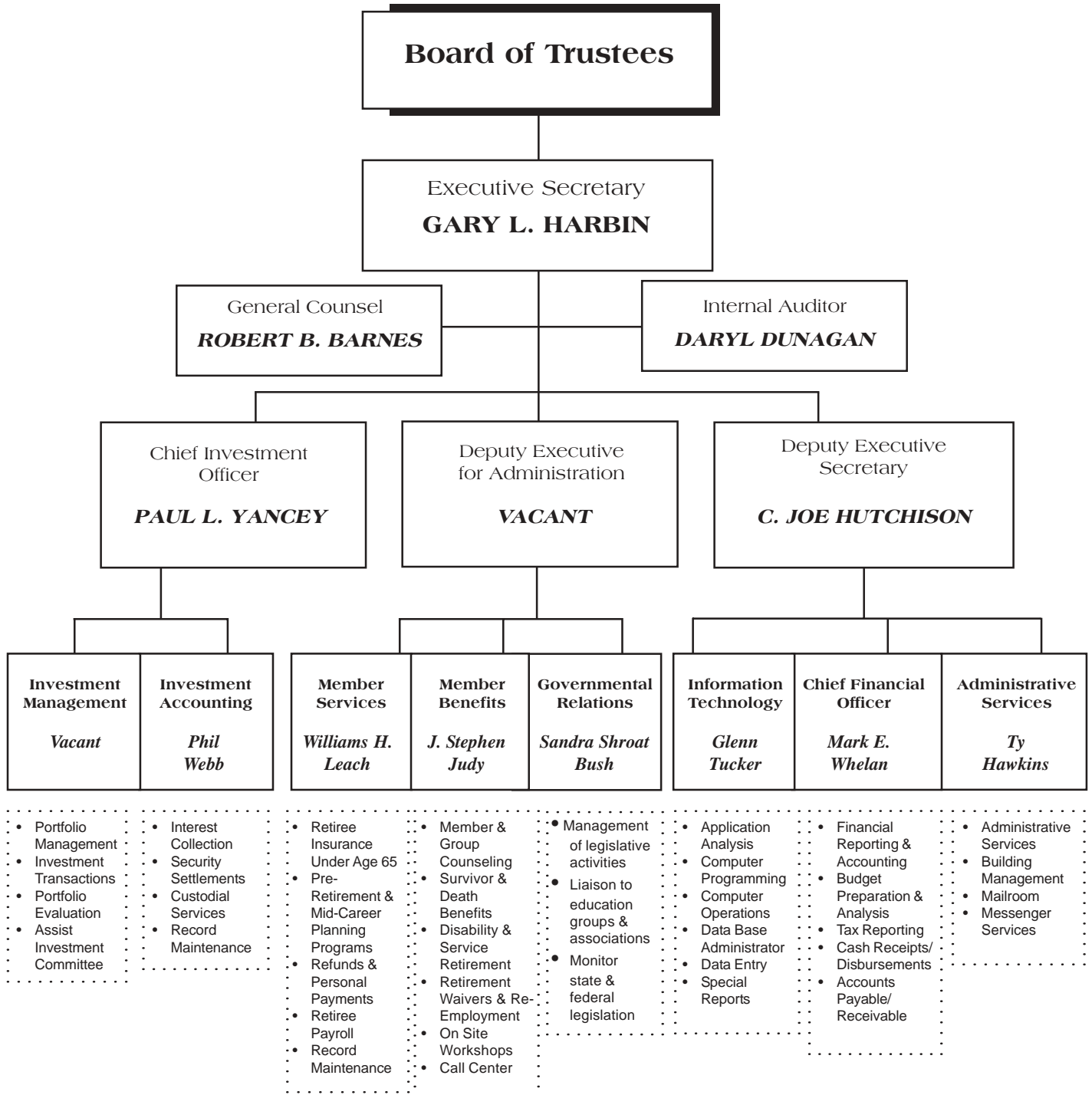
Cavanaugh Macdonald Consulting, LLC
665 Molly Lane, Suite 150
Woodstock, Georgia 30189

AUDITOR

Charles T. Mitchell, LLP
201 West Main Street
P.O. Box 698
Frankfort, Kentucky 40601

** See page 47 of the Investment Section
for investment consultants.*

Kentucky Teachers' Retirement System Organizational Chart



Certificate of
Achievement
for Excellence
in Financial
Reporting

Presented to

Teachers' Retirement System
of the State of Kentucky

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2005

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Carla E. Perry
President

Jeffrey R. Enos
Executive Director

GOVERNMENT FINANCIAL
OFFICERS ASSOCIATION (GFOA)

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Teachers' Retirement System of the State of Kentucky. The KTRS has received the Certificate of Achievement for the last seventeen consecutive years (fiscal years ended 1988-2005).



**Public Pension Coordinating Council
Public Pension Standards
2006 Award**

Presented to

Kentucky Teachers' Retirement System

In recognition of meeting professional standards for
plan design and administration as
set forth in the Public Pension Standards.

Presented by the Public Pension Coordinating Council, a confederation of

National Association of state Retirement Administrators (NASRA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Council on Teacher Retirement (NCTR)

A handwritten signature in dark ink, reading 'Alan H. Winkle', is positioned above the printed name and title.

Alan H. Winkle
Program Administrator

**PUBLIC PENSION COORDINATING COUNCIL
PUBLIC PENSION STANDARDS**

The Public Pension Coordinating Council awarded a Certificate of Achievement to the Teachers' Retirement System of the State of Kentucky for 2006 for implementing and maintaining high professional standards in administering the affairs of the System. The award is based on compliance with principles judged to underlie exemplary retirement system achievements in the areas of benefits, actuarial valuation, financial reporting, investments and disclosure and are widely acknowledged to be marks of excellence for retirement systems. It represents the highest standards of excellence in the public pension industry.

This page intentionally left blank.